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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Identification of accounting problems arising during privatization and their solution

Report of the Secretary-General

SUMMARY

Privatization, in one form or another, is a rapidly growing trend world wide. It is the central step in the transition to a market economy. This report, along with case-studies from seven countries, describes the motivations for privatization, the techniques used to transfer public assets to private hands and the problems which have occurred in the field of accounting. Many of these problems have arisen because new accounting systems are imposed on old ones and/or the quality of the data is insufficient to produce useful information. The most difficult area is that of the valuation of the enterprises to be privatized. Lack of good accounting information or the poor accounting practices of the past make this an exceedingly difficult job. Governments often give priority to rapid privatization, which makes accurate valuation almost impossible. This inevitably raises questions of social equity.

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INTRODUCTION AND MAIN ISSUES

1. At its ninth session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) discussed the accounting and valuation problems that arise during the privatization of State-owned enterprises around the world. Preliminary findings were reached at the session, but the Group felt that it would be useful to obtain case-studies of actual experiences, to date, in various countries throughout the world for discussion at its tenth session in 1992. Some members of the Group submitted information to the United Nations Centre on Transnational Corporations, and based on this and other data, seven case-studies were prepared and are included as addenda to this report. The case-studies are on: Czechoslovakia; France; Germany; Hungary; Mexico; Poland; and the United Kingdom of Great Britain and Northern Ireland.

2. The purpose of this report is to identify and clarify accounting and valuation problems that have arisen during the course of privatization in many countries. The objective is to discuss how some countries have dealt with these accounting and valuation problems and issues or, where they have yet to be resolved, suggest how they might be solved. These suggestions might prove useful to countries that are in the process of privatization programmes or are about to undertake them.

3. It is important to note that privatization exercises range from the diminution of government involvement in profit-making enterprises to a total withdrawal of the Government from business activities. Some prefer to describe it as "marketization" to promote efficiency and competition. The more radical the "marketization" process, the more accounting problems arise. The problems described in this report are extensive and in some cases concentrate on the experiences of countries in transition from a planned to a market economy such as in Central and Eastern Europe.

4. There is a significant difference between privatization in countries with market economies and countries in transition. Countries with market economies usually have in place all or most of the required institutions and infrastructures, such as: an established legal and regulatory framework; functioning financial markets for banking, insurance and buying and selling corporation shares; security as to private property ownership; an anti-monopoly policy; domestic price liberalization; trade laws and developed taxation systems. The adequacy of a nation's laws can affect accounting issues. New owners expect to acquire rights which can be protected in the courts. Many or all of these matters must be addressed by the countries in transition to a market economy.

5. Privatization programmes require a great amount of careful advance planning from both a political and economic standpoint. Once the basic decisions have been reached as to the privatization methods that will be used, appropriate enterprises must be identified, core businesses analysed, business plans with marketing strategies developed, financial statements prepared,

auxiliary and social services (such as garages, transport, living quarters and hospitals) disposed of or transferred to local government jurisdictions, excess administrative and operating personnel compensated and retrained, and surplus property and equipment disposed of.

6. Because most privatization decisions depend on high-quality accounting data, it is important that adequate time be available to analyse, separate and summarize transactions relating to enterprises and parts of enterprises. The results of operations and the financial condition of enterprises (and parts of enterprises) operating on a stand-alone basis may be very different from historical results.

7. In some countries, State-owned enterprises follow accounting principles required by the laws of the country although the private sector may follow generally accepted international accounting principles. In countries in transition, some or all of the accounting laws may not conform to generally accepted international accounting principles because of political considerations and perhaps the failure to appreciate the significance of utilizing international standards to meet the needs of investors from market economies who understand and expect to have financial data prepared in accordance with such standards. In addition, priority is placed on the speed of accomplishing the privatization process, sometimes to the detriment of accounting issues, particularly in arriving at accurate valuations of enterprises. Experience has shown that rapid privatization usually results in imprecise and frequently low values. Such outcomes can lead to social equity problems. Mistakes in valuation can be overcome by provisions for revaluations and adjustments at later dates to provide for fairness in transactions.

8. Although it is important to use international standards for presenting financial information to potential investors, if such information will also be presented to citizens who lack adequate financial sophistication, it must be presented in understandable form. This has not always been done. In converting to new accounting and reporting systems and procedures, provisions need to be made for adequate training of personnel. This includes an understanding of the fundamental concepts underlying the accounting principles and detailed guidance for how transactions are to be resolved and reported.

9. Finally, following the implementation of privatization, it is important for the Government to arrange for communication to its constituents of the social as well as the financial results of privatization programmes, including how social concerns were met and how well the Government's other objectives were achieved.

I. ACCOUNTING OBJECTIVES IN PRIVATIZATION

10. This report covers five major topics: transitional problems, valuation problems; inflation accounting, disclosure issues, and training issues. It is generally assumed that, whatever the context, accounting's overall goal is to provide useful information for decision-making. From the standpoint of the

prospective investor, accounting information should be reliable, consistent with international accounting standards, and useful for making investment and credit decisions and for estimating the nature and timing of cash flows. Because in traditional financial reporting, much useful information can be gleaned from the financial statements, information which presents fairly the status of enterprise resources, claims to resources, and changes in them should be provided.

11. The privatizing Government, on the other hand, is accountable to an entire community and should therefore set much broader objectives for the accounting and reporting function. From the standpoint of public expectations, therefore, accounting should provide information that is useful in the following ways: 1/

(a) For making divestiture decisions (such as the type of privatization method to use and its timing);

(b) For fulfilling the investor's decision needs, which usually includes, as a minimum, the preparation of a prospectus or information memorandum, and a business plan, including a financial forecast;

(c) For assessing how the public interest has been served in the Government's discharge of its stewardship function, including how well the privatization objectives have been met.

To meet the first objective, accounting should, as a minimum, help in assessing the privatization candidate's financial condition, the profitability of its various main activities, and the need for any organizational or financial restructuring. To meet the second objective, it should attempt to provide the investor with the types and quality of information described above. In each of these cases, the focus is financial and the accounts, therefore, play a key role, including the provision of basic data for use by expert valuers and investment bankers. Because many members of the general public - particularly in some developing countries and in former planned economies - do not have this level of understanding, their special needs as potential investors have to be considered in the design of financial reports for privatization purposes.

12. The third objective, that of measuring the Government's performance in serving the public interest, touches on matters that the accounts alone are not primarily intended to serve. Governments need to report on social concerns relating to former State industries. Accordingly, a privatization social report is proposed in the section on disclosure issues.

13. The human resource dimension is stressed throughout this report, because its importance is often not appreciated when considering the accounting implications of privatization. Examination of the first major topic, that of transitional problems, commences with the organization of the accounting function and then examines the usefulness of the information that it provides.

II. TRANSITIONAL PROBLEMS

A. Comparison of privatization in market and planned economies

14. When Western enterprises are privatized, they are often reorganized and nurtured to a profitable state. At the time of privatization, they already have a track record of success and a management team which is capable of running the privatized enterprise. Prior to privatization, the enterprise will be evaluated by experts with years of experience in the flotation of shares and the setting of share prices. The experts will have available historical data on the prices at which other similar flotations were successfully sold in the stock market. The prices will also be based on future prospects, but due diligence procedures will have been applied using, inter alia, a review of the recent history of operation to determine the reasonableness of the estimates of future profitability. The markets of the enterprises being privatized will be fairly stable, so that their track records will play a major role.

15. When enterprises in countries in transition are privatized, the situation in terms of useful information is very different, and sometimes little can be learned directly from Western experience. Generally,

(a) There is no reliable track record of operations that is useful for forecasting future results;

(b) The enterprise is usually not viable as a going concern without major restructuring;

(c) There is no marketing experience in the enterprise; labour relations may be poor and there is great need for management development;

(d) There are no Western-style financial statements or budgets, and no local staff skilled at producing and interpreting them for users of financial information;

(e) There are no systems in place to monitor the achievement of plans on a timely basis; bookkeeping systems have largely broken down, and management accounts as known in the West do not exist.

B. Organization of the accounting function

16. A major problem in the transitional period from a planned to a market economy lies in the need to provide for a logical restructuring and regulation of accounting and accountants in the public interest. In former planned economies, in particular, but also elsewhere, the Ministry of Finance usually was responsibe for accounting standards and oversight of professional qualifications. As economic reforms and privatization measures are introduced, however, jurisdictions can become fragmented, allowing for various inconsistencies and gaps.

17. The three former planned economies most actively engaged in the privatization process - Czechoslovakia, Hungary and Poland - have drawn up new accounting legislation that would bring the accounting function out of its period of stagnation. Hungary's new act on accounting (1991) is the most comprehensive of the three and complies more fully with international accounting standards than the new accounting laws of Czechoslovakia and Poland. The former German Democratic Republic will use accounting standards which comply with the European Community Directives following the unification of Germany. Additional information on the new accounting laws for these three countries is contained in the relevant case-studies (E/C.10/AC.3/1992/5/Add.1, 4 and 6.

C. Changing accounting practices

18. Some of the main types of problems connected with gathering and preparing accounting information which could be useful for investors stem from changes in the accounting entity, changes in accounting systems, and the general quality of the accounting data that are available.

1. Changes in the accounting entity

19. Accounting information may be difficult to generate, or reconstruct, when an entity with centralized accounting records is organizationally restructured. In the European Community, one of the most common examples of this dilemma has been splitting off the postal and telecommunications services, as described in the French and British case-studies (E/C.10/AC.3/1992/5/Add.2 and 7, respectively). In former planned economies, where industrial groupings tend to be extremely large, attempts to segregate past accounting transactions may present so many challenges that cost-benefit considerations may dictate the use of estimates in lieu of more exact approximations.

2. Change in the accounting system

20. Even when past accounting information can be reliably identified with a particular accounting entity, it may have been prepared on some basis which is not acceptable for commercial purposes. The most common examples are cash-based or fund-based accounting systems.

21. Cash-based accounts of public sector units are maintained in many Governments around the world, particularly if the units are budget-supported rather than revenue-generating. Cash-based systems may vary in sophistication from simple records of cash flowing in and out to computerized designs which provide for interperiod adjustments similar to accruals.

22. There are two main distinctions between cash-based systems and accrual accounting used in commercial enterprises: the balance sheet does not include receivables or payables; and the income statement reflects revenues received,

rather than revenues earned, and expenses paid, rather than expenses incurred and matched against revenues earned. Because the focus of cash-based accounting in government is on providing public services within budgeted appropriations, there is no perceived purpose in following the revenue-expense matching principle of accrual accounting unless it is necessary or useful to measure the costs of providing these services. Consequently, outlays for capital items such as buildings would appear as an expense on a governmental unit's statement of revenues and expenses. As described in the British case-study, problems connected with identifying capital asset acquisitions and the necessary use of estimates in allocating revenues between fiscal periods contributed to the auditors' decision to disclaim an opinion on the 1980 and 1981 financial results for British Telecom (E/C.10/AC.3/1992/5/Add.7). An inability to present several years' comparative data and the concerns of market regulators and investors over the nature of the auditor's opinion, can seriously affect public flotations or trade sales for privatizing enterprises.

23. In planned economies, State-owned enterprises generally follow fund-based accounting practices in accrual-based systems. Because the data required from the accounting function of economic enterprises in those countries are used primarily for the information needs of the central planners and statisticians, the chart of accounts and instructions for recording transactions are highly detailed and rigid in application. Decisions as to the methods of classifying transactions and recording production cost flows and the interperiod allocations of revenues and costs, such as depreciation and amortization, were not left to the discretion of the management and the accountants of individual enterprises. There were no individual investors or creditors whose needs had to be satisfied, but determining the material costs of production in a uniform manner was necessary for calculating national income.

24. Essentially, fund-based systems involve keeping separate sets of accounts for different cycles of operations, including production, capital investment, and special-purpose activities such as the construction and maintenance of employee housing, child-care facilities, and vacation hostels. Close equivalents to this integrated fund-accounting approach are found in accounting for colleges and universities in the United States and in capital and revenue transaction accounting by local authorities in the United Kingdom.

25. In order to prepare commercially oriented financial reports, previously segregated fund-based transactions have to be restructured and consolidated. This requires an expert understanding of the original recording process which foreign experts generally lack. Examples will be presented below of problems with both the quality of the data that these systems have produced and the lack of interperiod comparability which results from restructuring and consolidating the financial reports.

D. Quality of the accounting data

26. The quality of the accounting data assembled from past transactions, particularly in the transition from a planned to a market economy, is generally considered to be inadequate for providing reliable information to investors, based on various experiences with privatization audits. This is due to a number of factors, such as: concentration of bookkeeping and fiscal regulations in the same standard-setting body; the emphasis on production, rather than profitability; and the lack of external accountability.

27. The fact that State-owned enterprises generally provided the State with its revenues meant that the tax collectors were more concerned with formulating accounting rules that had beneficial fiscal effects than with indicating an enterprise's actual performance. Examples of such mechanisms are arbitrary revaluations of fixed assets, unrealistic depreciation rates, and charges for the use of State-provided resources.

28. The production orientation of State policies and the lack of interest in, or concern with, competition and profitability at either the macro or the microeconomic level meant that managerial and financial accounting skills were underdeveloped or virtually non-existent. Managerial accounting's potential for contributing to scientific management was inhibited by such factors as the lack of adequate cost centres, standardization of cost accounting systems, and absence of scientific costing techniques. A general preference for centralizing accounting records made it possible for large conglomerates or multi-unit enterprises to maintain only one responsibility-accounting centre, as contrasted with the multiple responsibility-accounting centres typical of competitive firms. In the privatization of some State-owned enterprises, it has been difficult to determine needs for organizational and financial restructuring because of the lack of information available about the degree to which different activities, processes, or product lines contributed to the overall financial results.

29. The lack of responsibility-accounting centres also meant that there was little concern with evaluating investment decisions. Such concepts as the time value of money, pay-back periods, risk assessments, inflation adjustments, and discount rates which guide the determination of return on investment in market economies were either underdeveloped or quite unknown.

30. Government policies which kept enterprises "cash poor" for control purposes and required bank financing for certain activities, such as inventory acquisitions, coupled with the soft budgetary constraints that underlay the bargaining for subsidies between enterprises and the centre, meant that there was virtually no understanding of micro-economics and financial management at the enterprise level. Such tools as cash budgets, cash flow projections, and analyses of cash flows were not called for, or used, where there was no local financial management and where decisions tended to be short-run in orientation because of the lack of stability in government policies.

31. Lastly, the accounting and finance personnel at the enterprise level are largely unaware of not only the new accounting systems but also of the

concepts which underlie them. This difficulty is compounded by the fact that in the transition period new economic structures are not sufficiently numerous to convey a sense of either the functioning of a market economy or accounting's role in it. Further, the personnel have long been accustomed to very explicit, mandatory accounting practices where penalties could be exacted from the employee personally for non-compliance, and punitive legislation possibly enacted retroactively. Therefore, there is often an understandable reluctance to implement new reforms.

III. VALUATION ISSUES

32. Certain valuation problems, as well as the necessity for valuation itself, are often not well understood in privatization exercises. There is often confusion about or difficulty in distinguishing three separate issues: the valuation of assets and liabilities; the valuation of the business as a going concern; and the determination of the final sales price. The three are often related but they are seldom if ever identical. If the Government is to maintain its credibility in the privatization process, care must be taken in the valuation of the enterprises to be privatized. It might be relatively easy for a Government to decide which enterprises are not strategic and therefore can be transferred out of the public domain. It also might be easy to decide how this transfer is to take place - whether through trade sales, stock flotations or management/employee buy-outs. It is much more difficult to decide what the enterprise is worth and what is a reasonable price to pay for the transfer of assets from public to private hands.

33. When purchasing an enterprise in the West, investors will usually want to review financial statements (for the current status and a report on recent history) and a business plan. They will amend the business plan to reflect their plans for the enterprise and to reflect any synergy effects resulting from the acquisition as seen by themselves. It is clear to a buyer that an investment decision is based on the enterprise's future prospects and not on the value of equity as disclosed in the balance sheet; the balance sheet shows those assets and liabilities which are to be taken over together with "the business" as such, and is useful for arriving at a purchase price.

34. Every attempt has to be made to avoid the public perception that assets were undervalued and sold too cheaply or that they were overvalued and could not be sold because prices were too high to attract investor interest. A lay reader may think, however, that the balance sheet in some way is a calculation of the enterprise's net worth. While the opening balance sheet is a useful guide, it is only one component in the valuation formula. The widespread misunderstanding of the role of the balance sheet - in particular by certain sectors of the press - can be very harmful to the success of a privatization programme.

35. Some Governments have been more concerned with effecting a rapid transfer than with ensuring that a price is fair. A proper valuation will serve, at least, as a benchmark or as a floor to the sales price even when there is only one buyer. Other reasons for undertaking a proper valuation include:

(a) Determining whether restructuring or closure is necessary;

(b) Estimating the amount of finance capital needed;

(c) Estimating the tax assessment and tax revenues;

(d) Determining the correct valuation for the opening balance sheet for the tangible and identifiable intangible assets and liabilities, to minimize the amount attributable to goodwill (the excess of the purchase price over the proper values of the net assets acquired);

(e) Determining the amount of actual capital employed.

36. It should be noted that the valuation of an enterprise based on its net assets usually differs from the valuation based on the enterprise as a going concern. Going-concern value is defined by Campbell and others (1990, p. 176) as:

> the present value of all future benefits expected to accrue from ownership, where a business operation is expected to continue to operate either for a finite period, or indefinitely into the future.

The resources yielding these future benefits include the net tangible assets needed for operations, any specific and identifiable intangible assets, and possibly the non-identifiable intangible asset commonly referred to as goodwill. The aggregate value of these resources, determined on the basis of value in use, minus all liabilities, provides an important indication of the overall value of the business. If, on the other hand, business assets are to be sold piecemeal for alternative uses, other valuation bases, such as market value, would be used.

37. Another distinct, but related, issue in the determination of the selling price of an enterprise is the negotiations between the buyer and seller. The selling price is likely to differ from the going-concern business valuation for a number of reasons, including the different motivations and bargaining strengths of the two parties. The Government is interested not only in the sales proceeds but also in certain macro goals such as maintaining employment, the inflow of foreign direct investment, and balance-of-payment equilibrium. The buyer, on the other hand, may be interested in future income streams as well as increasing his market share.

A. Valuation of assets and liabilities

38. The valuation of the assets and liabilities is difficult for many reasons. The net asset position shown on the balance sheet is often based on historical costs and, therefore, does not take into account subsequent changes in the value and condition of the assets. Resources which once had value, particularly productive assets, might now be valueless because they embody outmoded technologies. There is also the problem that some items may be

missing from the balance sheet, such as land, certain intangibles, and various liabilities such as pension benefits, post-retirement health-care costs, and contingencies for environmental damage.

39. The valuation of assets and liabilities is difficult if asset values have been fixed for long periods of time or if they have been previously revalued in an arbitrary way and the trail of the original value has been erased. It is also important to take into consideration the fact that, for those countries in transition to a market economy, enterprises will become subject to international competition, which may threaten their existence. This may call for use of break-up or alternative-use valuations. Identification of resources or liabilities which a enterprise should record for the first time, such as intangible assets or contingent liabilities, may raise the problem that existing accounting laws either do not cover such items or give only minimal guidance as to whether, or how, they should be recorded and reported. Consequently, additional guidelines may be necessary or, possibly, the development of new national standards.

40. Although valuation methods are many and varied, certain approaches have become standard, or generally acceptable, for restating the assets of an enterprise in terms of their value in current and future use. It is inherent in the going-concern concept that, even though different valuation techniques may be used for individual balance-sheet items, they are all aimed at measuring value in use. 2/ It would not be appropriate, for example, to value land and buildings on the basis of an alternative and higher-value use for some other purposes, such as redevelopment, since that would preclude continuation of the existing business. Such a value could only be realized by closing down or moving to other premises. An alternative use might, however, be relevant to the overall value if it were, for example, higher than the breakup value of the remainder of the assets, after taking into account liabilities on closure, or if the existing business could be rationalized into part of existing premises, thus freeing a site without damaging the business.

1. Current assets

41. Attention is now turned to the ways in which balance-sheet item valuation methods are applied to individual asset and liability accounts and problems that have been encountered in the process. Trade accounts receivable should be valued at their estimated collectible amount, and worthless accounts written off. An allowance for bad debts should be established to be offset against the aggregate amount due from the remaining debtors. Due to the rapidly deteriorating economic conditions, collapse of markets, and general problems with liquidity being experienced in Central and Eastern Europe, assessing the net realizable value of receivables is difficult. Also, in certain former planned economies, inventory was shipped to certain enterprises in excess of their current and future requirements. Therefore, realizability of the receivables from currently owned or formerly owned State enterprises must be carefully evaluated.

42. Regarding inventories, in an enterprise facing competitive conditions, there may be significant amounts of obsolescent or slow-moving items which may require complete or partial write-offs. So, evaluation of the possible markets, and market prices, for goods available for sale may constitute an important consideration in establishing an appropriate provision for inventory losses. In making valuations, if historical costs are not considered to be proper, current reproduction or replacement costs are used, taking into consideration future prices and inflation trends. A simplified formula frequently used for current reproduction cost is net realizable value, calculated as estimated sales price, less selling expenses, less any costs to complete, less expected profit.

2. Intangible assets

43. Some intangible assets (e.g. licences, leasehold rights, franchises etc.) may be purchased from others, including governmental agencies. Other intangibles, such as patents, brand names and other so-called intellectual properties, may be internally generated by an enterprise at significant costs. A third type of intangible asset, usually called "goodwill", is the value of an enterprise in excess of the book value of its net assets. Accounting regulations in some countries require that all costs related to intangible assets are to be charged as costs of operations and not reported as assets. In other countries, some or all such costs may be capitalized.

44. While the tangible assets of a business may be separately examined and valued, both individually and collectively, the valuation of separable intangible assets may present some difficulties or involve more assumptions. However, if the intangible assets contribute to an enterprise as a going concern, they have to be assigned a value (Campbell, 1990, p. 176).

45. A number of approaches may be used for the valuation of intangible assets, and two important ones involve the calculation of either discounted marginal revenues or discounted earnings. The discounted marginal-revenue-approach values a particular intangible asset on the basis of the discounted value of the premium earnings it will generate for the business. Premium earnings are defined as those which exceed earnings from producing and selling a product which is similar but which does not benefit from the particular intangible (such as a brand name) being valued. This technique is very similar, in principle, to calculating goodwill as the discounted present value of earnings over and above a "normal" rate of return on a particular investment. The discounted-earnings approach values an intangible asset based on the discounted revenues that could be received from a third party if the particular intangible were leased, or licensed.

3. Property, plant and equipment

46. Land should be valued at its market value for existing use, assuming continuing use in the same or a similar business. Market value is defined as the highest estimated amount for which an asset would sell on the date of

valuation, in an exchange between a knowledgeable, willing buyer and a knowledgeable, willing seller, in an "arm's length" transaction, in which the parties act prudently and without compulsion.

47. Where there has been no free market in land, or land and buildings, there will be no evidence of comparable transactions until such a market has been established. This is particularly true in former planned economies or in developing countries where the State owns most of the land. Also, relative scarcity of real estate could be factored into potentially speculative valuation. Where little market guidance is available, however, regard must be had to first principles - that is, value is derived from the surplus of operating profit, over and above all expenses, after making adequate allowance for a proper return on the owner's capital in current assets, stock (inventory), and work in progress.

48. Buildings, equipment and other productive assets employed by the business should be valued at the higher of market value and value in continued use, which is often taken to be depreciated replacement cost. When the productive assets are of a specialized nature due to their particular construction, size, location, or other factors which require that they are rarely sold in the open market (except by way of sale of the business as a going concern), it may not be possible to establish market value. In such cases, the depreciated-replacement-cost basis is used. This is calculated as the current replacement cost of the buildings, site works, plant and equipment etc., less an allowance for depreciation which is attributable to functional, economic, or environmental obsolescence.

49. The depreciated replacement cost of the buildings and plant would take into account the cost of modern substitutes using modern materials and technology and having the same service capacity - that is, the same output. In considering obsolescence and depreciation, the lower operating costs and longer life of the modern substitute must be taken into account. Economic obsolescence would be reflected in the age and condition of the existing building and the likely cost of future maintenance and repairs, compared with modern items. Functional obsolescence would be reflected by suitability for present use having regard to changing technology and economic life of the present manufacturing process. Environmental factors should take account of current environmental requirements and the cost of complying with them as well as possible liabilities for past contamination requiring treatment.

50. In effect, depreciated replacement cost is a ceiling amount and subject to a test of adequate profitability, both potential and current, as compared with the total capital employed. If the target return on capital is not met, the assets should be written down to an amount that will provide an adequate return. In considering the amount of the write-down, the floor amount is the break-up or liquidation value. These values would also be appropriate if the enterprise cannot make profits, and they are calculated as the sales value of the plant without regard to a continuing business, either for scrap or to another user. Both break-up and liquidation value will usually be lower than value in existing use, because all special adaptations of the building for a

particular trade, for example, are valueless. An exception exists when the site has a high alternative-use value. If, on the other hand, profitability were to exceed the target return, goodwill value would exist.

51. In addition to productive assets, enterprises in economies in transition usually own property acquired for the benefit of the workforce, including employee housing and vacation hotels or sanatariums, kindergartens, and nurseries. These investments are listed as special-purpose assets on the balance sheet. As the economic situation worsens, enterprises have been seeking ways of disposing of these facilities so as to avoid the mounting costs of running and maintaining them. Arrangements could be made for the free transfer of title to employees, through a housing cooperative for example, but families accustomed to - and paid on the basis of - low-cost housing would likely not have the means to assume the financial burdens of ownership. For enterprises with such facilities, liquidation values rather than values in use would seem more appropriate.

4. Liabilities

52. Identifying and valuing all liabilities and segregating debt from equity may be difficult, particularly where enterprises have used fund-based rather than traditional commercial balance-sheet formats and did not record or report certain obligations, such as contingencies, or loans received from other enterprises to help cover operating costs.

53. As countries in transition started to change balance-sheet formats so as to conform with international practices, various reclassification decisions had to be reached, particularly certain debt versus equity issues. For present purposes, liabilities may be classified into several categories: current liabilities for trade payables, taxes and other amounts due which are usually invoiced; accruals for payrolls and various provisions such as for employee terminations, product warranties, etc.; and long-term debt.

54. Invoiced amounts usually present the fewest valuation problems, because amounts payable are definite and they are generally taken at face value except, possibly, where currency translation is needed. The main difficulty lies in ensuring that all liabilities have been identified and amounts due appropriately recorded, particularly where enterprises were not required to maintain sub-ledgers of debtors and creditors, as in Hungary, or did not periodically reconcile sub-ledgers to the control accounts.

55. Accrued liabilities generally stem from the accounting convention that expenses must be matched in the same period with the revenues that they helped to generate. Examples include interest accruing on notes payable, estimated amounts of repair work under product warranties on sales during the period just ended, and anticipated losses from transactions not completed, such as firm commitments to purchase materials in the next accounting period at prices higher than current replacement costs.

56. An enterprise's pension obligation is potentially one of the largest accruable liabilities that may be understated in the accounts, because underfunded pensions are a world-wide phenomenon. As described in the case-study of the United Kingdom (E/C.10/AC.3/1992/5/Add.7) the Government paid £47 million into the National Freight Company's pension fund before it was sold as a management buyout in 1982. At least three different approaches to the pension obligation have been employed: permitting employees of the privatized enterprise to remain covered by the public sector plan as generally provided for in the countries in transition; dividing up the pension liability between the various subsidiaries of a privatizing entity and restricting membership in an existing plan to those already covered by it; and enrolling the new employees of a privatized enterprise in a new pension plan.

57. Even though the Government may decide to remove pension debts from the enterprise's liabilities, prospective investors need to know how existing pension commitments affect income, financial position, and cash flows. In particular, information should be provided on the pension plan cost structure so that relatively stable service costs based on services rendered by employees can be distinguished from those made more volatile by other determinants such as actuarial gains and losses.

58. ISAR has made recommendations for accounting methods and for disclosure of pension cost commitments (United Nations, 1991a, pp. 105-108), as follows:

(a) Accounting for defined benefit plans - the costs directly related to services performed by employees - should be periodically accrued, using acceptable actuarial methods. Interest costs, actuarial gains and losses, and experience adjustments should also be recorded as costs, when known;

(b) Accounting for defined contribution plans - amounts which the enterprise intends to pay for the benefit of the workers - should be accrued when the obligation occurs;

(c) Disclosures - the footnotes to the financial statements - should contain descriptive information on the type of plans in existence, the enterprise's commitments thereunder, and a statement as to whether the plan is internally or externally administered; financial information on cost methods and underlying assumptions used, the amounts of current and prior service costs recorded, and actuarial gains or losses experienced during the year.

59. Provisions for probable contingencies also constitute an important consideration in valuing enterprise liabilities, and one of the most significant may be environmental clean-up costs. The past lack of concern over environmental issues, particularly in Central and Eastern Europe, and the absence of legislation to control, or make enterprises financially responsible for, operations that threaten health and safety means that huge outlays will have to be made for remedial measures. There may also be real problems in attempting to assess in monetary terms the damage for which an enterprise could be held liable. This is because of the degree of subjectivity in judgements about such basic issues as the extent and types of damage and the relative costs and benefits of alternative clean-up techniques.

60. ISAR has surveyed corporate practices throughout the world on information disclosure on environmental policies, performance and expenditures (see E/C.10/AC.3/1991/5 and E/C.10/AC.3/1992/3). Their studies found that very few enterprises regularly provide sufficient information in their annual reports on environmental matters. The report of the ninth session of ISAR contained recommendations for the following disclosures:

(a) Reports of the board of directors should include at least a description of the environmental issues that are pertinent to the enterprise, and their policies, programmes and achievements in the area; applicable government legislation and any known violations of such legislation; and amounts of capital costs and of costs charged to operations during the year;

(b) Notes to financial statements should disclose accounting policies for environmental expenditures, including contingency provisions.

61. Long-term debt and the related interest thereon should also be reviewed for the possible restructuring of troubled debt, as well as the reasonableness of the interest rate(s). In Germany, as of the day before general privatization, 30 June 1990, State enterprises of the former German Democratic Republic owed the State banks some 220 billion Ost marks, about half of which was absorbed by the Trust Agency. 3/ In determining how much debt should reasonably be assigned to the privatized companies, reference was made to the average debt to equity ratios for industries in the Federal Republic of Germany. Consideration was also given to the possibility of leaving to the new owners the responsiblity for carrying out any necessary financial restructuring.

62. It is possible, or highly likely, that after completing the valuation exercise, adjustments of other accounts may be needed in order to force equality between the two sides of the balance sheet. In Germany, the Trusteeship Act (Treuhandgesetz) of 1 July 1990, governing privatization in the new Länder, automatically converted combines into public companies and enterprises into private limited companies, each with differing minimum capital requirements under the Commercial Code. On the opening balance sheet for each new company, after the minimum capital is recorded, an equalizing debit was generally called for, to record, as an asset, a receivable from the Trust Agency. In the relatively unlikely event that there was an excess of assets, an equalizing credit reflected the company's liability to pay the excess amount to the Agency. Companies are allowed, until the end of 1994, to make any necessary corrections or adjustments to the opening balance sheet if errors were made in recognizing assets or liabilities or in making valuation or measurement judgements.

63. Because of the difficulties involved in making reasonable valuations of real property in the countries in transition, provisions in privatization agreements might provide for reassessments and adjustments at a later date, to build fairness into the process.

B. Business valuation

64. After the accounts have been restated in conformity with international standards, and the net asset valuation performed, a business valuation should be carried out, based on the enterprise's activities and future profitability prospects, thus combining past and present data. The timing of the valuation processes will depend on the chosen privatization technique. In the case of trade sales, valuation should take place in the early stages of readying the enterprise, before bids are invited from potential buyers. For share flotations and private placements, the business valuation may take place even earlier, depending on the monetary amounts involved, with updating of the various assumptions in the forecast as the exercise progresses.

65. Preparation of the basic data constitutes the first priority. A detailed business plan for the next several years - preferably, five - together with forecasts prepared in accordance with generally accepted accounting practices, provides the foundation for the estimates of future earning power. Other elements such as the type of business the enterprise conducts, markets and market shares, reputation for quality of products, management, and the workforce, and other key factors such as the availability of other investment opportunities and the returns they offer will guide the valuer's assessments of the rate of return which an investor would find attractive. Estimated future earnings and return on investment constitute the two key elements in the business valuation, underlying the various alternative techniques for arriving at a monetary amount.

66. The two most widely used methods for estimating business value, found in a number of variant forms, are the discounted cash flow and the price-earnings methods. The former is a present-value calculation of future cash flow expectations which has the advantage of indicating the timing of the return on investment. A discount factor is applied to the streams of forecasted cash flows to find their present value, and a residual amount is added to allow for the last period's earnings to continue in perpetuity. The discount factor should approximate the investor's expected rate of return, and its choice may prove challenging.

67. Because the expected rate of return involves comparisons with peer enterprises, calculation of the discount factor should include averaged data from enterprises with similar structures and in the same industry. A popular method involves computing the weighted cost of capital, which proceeds in several steps. First, the debt rate, or proportion of debt to equity, is calculated and adjusted for corporate tax effects, so as to put debt and equity on the same tax basis. Two types of risk premiums are then considered. A general equity risk premium, as adjusted by the beta factor for industry risk, is applied to the proportion of equity. A country risk premium is added to the weighted average cost of capital, to reflect the various risks inherent in the particular economy, such as inflation rates, the stability of markets, the political situation, and the convertability of the currency. In some countries, the assessment of the country risk premium may be so high and the quality of the available average data so poor that the reliability of

forecasted earnings is very questionable. In such cases, the discounted cash flow technique is not attempted.

68. The price-earnings method is a simpler approach which multiplies the annual earnings that a business is expected to maintain by the number of years of earnings which are typically paid for by purchasers of enterprises in that industry, as adjusted by one or more risk factors. The stock market is the usual point of reference, but if no stock market exists and no industry averages are available, the valuer will probably fall back on adjusting the averages which have been calculated in countries with economic similarities. If the earnings estimate lacks stability, however, other methods should be considered.

69. Alternative guides to business value include comparisons with values recently arrived at for similar exercises under similar conditions, calculating the market share that the enterprise enjoys and estimating the value of that market share to investors, and employing the market comparison approach. This approach analyses certain data from other enterprises comparable to the one being valued - in particular, the earnings before interest, depreciation, and taxes. These eliminations adjust for any differences between capital investment and financing decisions and for the effects of alternative tax structures and rates. Once again, country risk would have to be factored in.

70. In the emerging market economies, the absence of open capital markets makes business valuation extraordinarily difficult (Young, 1991, pp. 206-207). Enterprises reporting past profits may have had earnings boosted by subsidies, loans with low interest rates, rent-free facilities, and other advantages that they will not enjoy in the future. Further, some will be operating under competitive conditions for the first time. This challenges the valuer's ability to select an appropriate earnings multiple, to assess an enterprise's ability to generate cash flows, and to calculate discount rates in the face of the economic and political risks and uncertainties. For these reasons, among others, the reasonableness and fairness of the valuation process is going to be hard to demonstrate until the commercial community expands, capital markets have started to grow, and a database of business and asset sales can be built up (Young, 1991, p. 208).

71. A possible solution to a government's concerns about selling properties at too low prices would be to enter into leases for the use of the properties for a period of time until it is believed that fair market valuations can be made more accurately.

C. Sales price

72. After receiving the business valuation, the Government faces the difficult problem of balancing the necessity to maximize proceeds, particularly in view of public sensitivities in this regard, with the economic, political, and social objectives that are driving the privatization

process. 4/ This problem is particularly acute when there is a public share flotation and substantial premiums are recorded. This is often taken to mean that the shares were priced too low initially (which may be so), but may also be attributable to heavy investor interest which was not anticipated. Auction-based private sales may also yield low prices if the Government's financial needs restrict its ability to increase the number of potential bidders or raise the floor price. Legal limitations on holdings by capital-rich foreigners or other particular groups of investors may also bind the Government's hands. Social objectives may drive the Government to accept lower prices from managers and employees offering to buy out the enterprise or from an investor promising full employment in a depressed area rather than a higher offer from an investor who wants to acquire and close down a competitor.

73. Maximizing the transparency of the price negotiations so as to help the public understand the Government's motivations is a matter of public policy or practice in some privatizing countries. In the French case-study (E/C.10/AC.3/1992/5/Add.2) it was noted that the independent Privatization Commission determines the value of the business, or assets, to be privatized and that amount sets the floor for the final offering price determined by the Minister of Economy, Finance, and Privatization. An effective way for the Government to account for its protection of the public interest would be through a special privatization report, as described in section V below.

IV. INFLATION ACCOUNTING

74. In countries experiencing significant levels of inflation, financial statements based on original transaction values which do not give explicit recognition to the effects of changing prices could provide misleading information about enterprise performance, financial condition, and distributable wealth. When prices rise, purchasing power falls. Under hyperinflationary conditions, the economy can be affected dramatically, as shown by the Polish experience where purchasing power in 1987 was 31 times greater than in 1990. In traditional, historical cost-based accounting systems, costs and expenses, such as cost of sales and the depreciation of fixed assets, which originated in prior periods with higher purchasing power, are deducted from current period revenues with lower purchasing power. The same calibration problem exists with balance-sheet values where different levels of purchasing power are aggregated to arrive at the financial condition. Without a clear picture of enterprise performance for a given period and financial condition at the end of that period, it is difficult to make rational decisions about the distribution of the recorded accumulated earnings. Dividend distributions or pay increases, for example, may actually be depleting capital rather than sharing wealth if earnings are not inflation-adjusted to provide for capital maintenance.

75. In 1989, the Intergovernmental Working Group studied the question of accounting for inflation and changing price levels, as compared with historical values of assets and liabilities for business enterprises (United Nations, 1990, chap. III). The Group defined hyperinflation as inflation of

approximately 100 per cent or more on a cumulative basis over a three-year period. It recommended that the primary financial statements of enterprises in a country with hyperinflation should reflect price-level adjustments, to make the statements more meaningful. This should be done by using a general price-level index.

76. The general problem in emerging market economies at the present time is that basic financial data is not recorded in accordance with generally accepted accounting practices world wide. Historical cost-based comparative data have little, if any, predictive value. This, combined with the fact that privatized enterprises would be operating in a completely different economic environment suggests that adjusting past data for changes in purchasing power may serve little useful purpose. This is because the net assets of the privatized enterprises may be used in a way completely differently from before. Also, the book value of such assets may be greatly in excess of the book values of similar assets of enterprises in free-market economies. This could mean that comparison of financial information between similar industrial enterprises would not be useful.

77. The Government of Germany uses replacement cost, rather than indexing, for valuation purposes because of the perceived poor quality of the reported accounting data in the former German Democratic Republic, particularly with respect to property, plant, and equipment. However, performing this work required the engagement of a substantial number of professional accountants, at considerable cost. Other countries prefer to use indexing, which is significantly easier to understand and to apply, even though it lacks the appropriateness of replacement cost methods, as referred to above.

78. The situation calls for continuing efforts to bring about more awareness of the effects of inflation, particularly on the part of the standard-setting bodies in the emerging market economies, where purchasing power is undergoing rapid change. It should also be recognized that inflation is not uniform in its effects. As the Polish case-study of the five large privatizations showed (E/C.10/AC.3/1992/5/Add.6), inflation rates may vary by industry within the same time-frames. Intra-industry effects may also vary, depending, for example, on relative debt to equity capital structures of particular firms.

79. ISAR's 1989 recommendations merit renewed consideration because of their particular relevance in the context of privatization.

V. INFORMATION DISCLOSURE

A. Information disclosures in privatizations

1. Financial disclosures in privatizations

80. One of the main objectives of supplying financial information to the general public and other potential investors for privatization purposes is to enable them to assess the risks and benefits of their investment options and, thus, to protect their interests. This means that the financial information

should present the financial position and results of operations of the privatizing enterprise fairly, that the financial information should be verified, or attested to, by an independent auditor, and that other pertinent information should also be furnished. The two main ways in which such disclosures are made in privatization exercises are through the publication of a prospectus for the issuance of securities or of an information memorandum in the case of a trade sale. While both documents have standardized sets of contents, the information memorandum is generally tailored to the perceived interests of specific investor groups.

81. Information about the public offering and the economic and financial status of the issuer of securities is the main element of a prospectus. Details of the issuer's past business history and comparative financial data for several prior years, attested to by independent auditors, and a business forecast are generally required.

82. The main objective of an information memorandum is to interest potential buyers or investor groups, particularly those that can assist with developing new markets or bring in technical skills. It is generally assumed that the users of the memorandum will be experienced in analysing and evaluating the data presented, that specific information will be pertinent, and that past financial data may be of considerably less interest than future prospects. Sometimes an auditor is engaged to comment on forecasts that appear in the statements.

83. The financial data should include a balance sheet and income statement for at least the prior two years plus the current partial year, prepared in accordance with international standards, together with various enclosures, including an analysis of the enterprise's financial condition through the use of various types of indicators, such as liquidity and profitability. The memorandum should also include a description of the enterprise's marketing situation and of its organizational structure.

84. In privatization exercises, where national property is being disposed of, it is particularly important to tailor information supplied to the public - generally through a prospectus - to the needs of small investors. Hungary, in particular, was sensitive to this issue in preparing comments on the Act on Securities and the Stock Exchange (1990).

85. Of all the economies in transition, Poland has made the most use of the public share flotation technique. The contributions of small investors to the expansion of the Polish capital market were quite substantial, as the public subscriptions for the first five large privatizations at the end of 1990 showed. The overwhelming majority of the shares offered were purchased by small investors, most of whom were, unfortunately, unable to use the prospectuses effectively, as described in the Polish case-study (E/C.10/AC.3/1992/5/Add.6). Therefore, when share subscriptions are offered in privatization exercises and small investors are being relied on, the information may have to be disclosed in two formats: a formal prospectus, and a simplified version. Because, in either a share flotation or a trade sale,

all interested parties have to receive the same information, the two versions of the prospectus would have to be presented as a package. In the simplified version, some of the excessive detail should be removed and explanatory, analytical data added. Data from the formal prospectus should be condensed and key financial ratios calculated and explained. Together with the main performance indicators, indications should be given of the range of values which one would expect for enterprises with comparable production profiles, business history, and so forth. Explanations should also be provided if, as described in the section on valuation, there are circumstances which preclude the use of prior data as a guide to the enterprise's potential for profitable operations. Also, the financial statements should be presented with explanations about the functions they serve and the information that they portray, together with appropriate analyses. Similar information should be provided to the members of the workforce as an incentive to those who might not have otherwise considered becoming partial owners in their own enterprise.

86. The availability of information about privatizing enterprises in languages and formats that are easier to understand than traditional disclosures, and yet not at the same time misleading, should help to expand the number of potential investors and thereby help the Government to gain acceptance for its efforts. Public perceptions of the way in which the Government is fulfilling its duty to protect the public interest may also be favorably influenced by the periodic issuance of special-purpose reports about the ways in which the privatization objectives are being accomplished.

B. Special-purpose privatization reports 5/

87. Major social groups, such as consumers, taxpayers, employees, unions and their elected representatives, and the Government itself need to know whether privatization programmes have accomplished their principal objectives. A discussion of these issues is included in the Secretary-General's report on accounting and reporting during and after the transition from public to private enterprises (E/C.10/AC.3/1991/6, pp. 7-8). Public bodies are usually responsible for such a wide range of duties, within even limited spheres, that, according to Vickers (1952, p. 73):

> Achievements ... cannot be measured or even recorded in money or in financial accounts. They can only be set out in narrative and in statistical summaries, only a small part of which can be financial.

88. The importance of supplying social information within or together with financial reports takes on a new dimension in the context of privatization. The social implications of privatization are so significant when carried out on a large scale that a privatizing Government should issue a special-purpose privatization report, using a format considered most appropriate under the circumstances, during the privatization process and at future annual intervals, as appropriate.

89. The indicators presented in the Government's report should, of course, relate to the major privatization objectives. Social benefits quantifiable in

monetary terms could include subsidies saved, losses avoided, and capital expenditure obligations escaped, as well as increases in various revenues from profitable privatized enterprises. Monetary social costs could include unemployment benefits and other human resource costs such as costs of safety nets and retraining costs, costs of increased regulation (net of savings from decreased regulatory activities), costs of compensating privatized enterprises for providing non-commercial services or products, and so forth. Repercussions on foreign exchange positions and on the balance of payments also need to be addressed. It may well be, however, that certain other indicators, such as efficiency measures, employment levels, and the composition of business ownership, do not lend themselves to monetary measurement and will require identification in narrative, descriptive form.

90. Under certain conditions, some enterprises might be required to report on how they have met the obligations that they assumed when they acquired ownership of public property. This is particularly relevant when the enterprise submitted a business plan as part of its purchase offer. Requiring an enterprise to account to the Government for its success in meeting the declared intentions that helped it acquire ownership should improve both the bidding process and public acceptance of transactions.

91. Whatever the selected format and contents, the report should be designed to help the public assess the success which privatization has achieved. In summary, a well-designed and presented special-purpose report, preferably presented to the legislative body for review, debate, and acceptance would help the public to assess how the Government has discharged its stewardship function and its success in meeting privatization objectives, and could be useful in improving or enriching privatization planning. Without accountability, questions arise as to the basis for public trust, particularly when economic conditions are severe.

VI. TRAINING OF ACCOUNTANTS AND AUDITORS

92. The transition of an enterprise from being government-controlled to being part of a market economy brings with it the necessity to adequately train the management and employees. If only a few enterprises are being privatized within a country, the task of training managers, sales personnel and financial personnel is important but not overwhelming. Personnel can be hired from other parts of the economy, and consultants can be used for training and staff development.

93. However, when an entire country is in transition from a planned economy to a market economy, the necessity for training is fundamental and substantial. Basic structural changes have to be introduced into the economy, including accounting reform. This means that all practising accountants and their managers, as well as educators, must be trained in new accounting methodologies so that they can operate the systems and procedures appropriate to the market economy.

94. One of the Secretary-General's reports to the Intergovernmental Working Group includes a description of issues and progress being made in the field of accounting training in countries in transition (E/C.10/AC.3/1992/7).

Notes

1/ The statement of these objectives benefits from the unpublished observations of Prof. V. V. Ramanadham.

2/ This section benefits from the unpublished commentaries of Mr. Kenneth Easter of the International Assets Valuation Standards Committee.

3/ Private communication from privatizing offical.

4/ For a summary of these problems refer to Vuylsteke (1988), pp. 109-116.

5/ This section is based on the unpublished observations of Prof. V. V. Ramanadham.

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